Update

Edison investment research

21 December 2009

China Real Estate Opportunities

Year End	Revenue (£m)	Adjusted PBT* (£m)	EPRA NAV/ Share (p)	Disc. to NAV (%)	DPS (p)	Yield (%)
12/07	8.8	(10.9)	834	63	0.0	N/A
12/08	25.3	(113.5)	1,324	77	0.0	N/A
12/09e	26.9	(4.3)	1,027	70	0.0	N/A

Note: *Adjusted PBT excludes goodwill amortisation and unrealised movements in portfolio valuations. EPRA NAV excludes deferred tax and MTM changes in derivatives.

Investment summary: Improving FY10 outlook

CREO's latest announcement may focus specifically on new facilities and lettings, but is actually the latest of a series of ongoing initiatives that strengthen the financial outlook and address the main issues of concern at the outset of FY09. During H209 it has revised the management fee structure to preserve cash and sold its stake in a Shanghai development at c 9% above the FY08 valuation (undermining predictions of sharp falls in Shanghai investment property values). By December it had completed lease renewals, extensions and new lettings, without cutting rents, improving the revenue profile. That attests to the stability of the local real estate market, but also the quality of the portfolio and success of asset management initiatives. That the valuation, at 70% below NAV, has yet to respond to these steps may be due to a material stock overhang, solutions for which are also under consideration.

Portfolio responding well to active asset management

A year that included c 170 lease expiries provides a useful guide to local market dynamics. Although some tenant turnover was expected, a number also agreed 5-10 year extensions to previous three-year leases and rent rises pushed up the gross rent roll y-o-y, despite an increase in overall voids. The Central Plaza refurbishment will be completed early 2010 with new leases at around four times previous per sqm rent.

Support from local PRC bank removes doubt

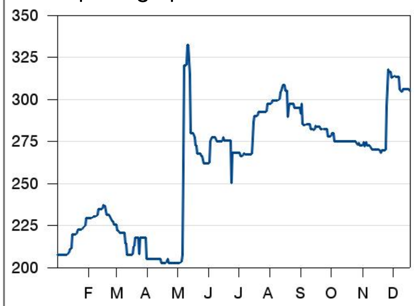
The successful refinancing of existing debt secured on the Treasury Building in Shanghai proves that there is support for the right kind of asset. The new facility from CITIC Ka Wah Bank in Hong Kong immediately replaces the existing Credit Suisse loan, with a three-year term and a material reduction, ie c 40% in interest costs.

Valuation: NAV discount should close as issues fall away

The group emerges from H209 with the revenue outlook and finances in far better shape. A sizeable NAV discount may increasingly be due to technical factors eg stock overhang. The recent announcement of a possible zero dividend preference issue is one initiative designed to achieve this. Others may be in the pipeline.

Price	305p
Market Cap	£151m

Share price graph



Share details

Code	CREO
Listing	AIM
Sector	Real Estate
Shares in issue	49.53m

Price

52 week	High	Low
	335p	201p

Balance Sheet as at 30 June 2009

Debt/Equity (%)	62
EPRA NAV per share (p)	10.62
Net borrowings (£m)	249

Business

China Real Estate Opportunities actively manages a portfolio of commercial real estate investments, supported by planned developments in key Chinese cities such as Beijing and Qingdao.

Valuation

	2007	2008	2009e
P/E relative	17%	N/A	N/A
P/CF	N/A	13.2	N/A
EV/Sales	30.2	17.1	15.8
ROE	12%	N/A	N/A

Revenues by geography

UK	Europe	US	China
0%	0%	0%	100%

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China Real Estate Opportunities is a research client of Edison Investment Research Limited

Active asset management improves outlook for FY10

In common with most of the quoted property sector during 2009, CREO has had to overcome considerable investor scepticism regarding the outlook for the industry. A review of the year, particularly H209, suggests that it has navigated a difficult year with some success. The Shanghai real estate market has been steadier than many anticipated, but the energy expended by to actively manage its assets is the main source of progress. That has yet to be reflected in the valuation, but newsflow during Q110 may provide the catalyst for a re-rating.

Attention to addressing operational and technical issues in FY10

Rent reviews and negotiations with banks are ongoing tasks for 2010. CREO may also need to address a couple of other key issues as it heads into the New Year. One is the uncertain outlook for its developments in Beijing and Qingdao. Both are currently mothballed and carry no debt, but if they are unlikely to proceed in the short term, the cash tied-up may be better invested elsewhere.

Another non-operational issue for investors relates to the intentions of the major shareholder, REO, whose 15% stake may be helping to anchor CREO's shares at a 71% discount to prospective NAV. Management regards this as a strategic priority and is considering a number of initiatives.

This first is the possible zero dividend preference share issue, the proceeds of which would be applied to share repurchases to eliminate the overhang. The group has also previously discussed a possible listing on an Asian market, to attract investors more familiar with local property market dynamics. We also believe that it may accept offers for its non-core development assets, the proceeds of which will improve the cash position.

Tenant initiatives reap rewards

Active asset management helped ratchet portfolio improvements in FY09 and helped resist fierce competition for tenants from other commercial space in Shanghai. CREO has processed over 170 leases this year, c 100 of which were renewed and c 50 leases signed with new tenants. The most important was the retention of SPX Corporation as the major tenant in the Treasury Building.

The property is a Grade A office building developed in 2007, located in Shanghai's Changning District 4km from the Bund. SPX, a global Fortune 500 multi-industry manufacturing company, agreed a three-year extension from March 2010. Some rationalisation of SPX's requirement released space most of which has been let on a 10-year lease to The Bank of Beijing at a 25% premium to the previous rent. The building is currently approximately 90% let.

Exhibit 1: Investment portfolio valuations at end June 2009

Property	Type	Value RMB Bn	Value £Bn	Office Space Avg. rental growth pa (last 10 years)	Retail Space Avg. rental growth pa (last 10 years)	Major Tenants
City Center 1	Office & retail	5.39	0.49	5.64	5.82	Parkson, Unilever, Brother, Honeywell, Davis Langdon & Seah
Central Plaza	Office & retail	1.53	0.14	5.82	6.25	Boston Consulting Group, H&M, Metlife, Everbright Bank
Treasury Building	Office & retail	0.60	0.05	5.00	4.82	SPX, Treasury Holdings China, Starbucks, Sony
		7.52	0.68			

Source: CREO documents

Refinance for Treasury Building: Local bank support for the sector

The group has also allayed fears that it might not be able to refinance bank facilities or assets. On 10 December it announced completion of a new, multi-currency three-year loan for £27.7m equivalent (US$37.8m offshore loan and RMB50m onshore) with CITIC Ka Wah Bank in Hong Kong. This is secured on the Treasury Building and replaces an existing €18.8m/RMB97m Credit Suisse facility (c £25.8m) due to expire in March 2010.

It is also reassuring that the new facility is at a much lower interest cost ie 3.50% over the relevant base rate for each foreign currency component and an all-in 6.37% for the RMB portion. That is a blended c 4.20% pa cost, compared with over 6.75% for the current loan.

Exhibit 2 sets out CREO's current borrowing position ie including the new loan, but portfolio valuation as at end June. The Treasury Building was revalued at the end of October as part of the formalities for the CITIC Ka Wah Bank facility. Management has confirmed that the property was appraised at a higher value, in line with the improved rent visibility derived from new tenants and lease extensions. As details were not released, we have adjusted for this in the table below.

Exhibit 2: Group debt & Loan-to-Value

Note: [1] Valuation at end June 2009; [2] Excluding Treasury Building; [3] Total loan book, property values including Treasury Building at end June 2009.

	Loan	CNY Equiv. (m)	Property Value RMBm	LTV
Investment properties				
City Centre				
US$ Loan	$236.53			
CNY Loan	RMB820.00	2,436	5,390	45%
Central Plaza	$236.53	731	1,532	48%
The Treasury Building				
US$ Loan	$37.80			
CNY Loan	RMB50	307	600 [1]	N/A
Total investment property LTV		3,167 [2]	6,922 [2]	46% [2]
Development properties				
City Centre Extension	0.0	0.0	1,213	0%
Beijing Logistics Park	0.0	0.0	99	0%
Tangdao Bay	0.0	0.0	637	0%
Total development property LTV			1,949	0%
Total portfolio		3,474 [3]	9,471 [3]	37% [3]

Source: CREO documents.

CREO is building relationships with local institutions and has commenced discussions regarding the refinance of its biggest loan, secured on City Centre 1, due in 2010. It is also seeking to arrange development finance for the City Centre extension as part of that facility. That development is likely to drive significant longer-term value for the portfolio, both asset values and rental income and, over time, could transform the group's financial position.

Portfolio valuations verified by sale of CC5

We believe other milestones in H209 assist the outlook for 2010. In June, the group sold its stake in the City Centre 5 development at a price c 9% above the year end valuation. This helps ratify the external valuation of the portfolio which, given a difficult year for property values globally, may obviate investors' concerns regarding year-end values and the strength of the balance sheet.

Exhibit 3: Financials

£000	2007	2008	2009e
Year end 31 December	UK GAAP	IFRS	IFRS
PROFIT & LOSS			
Revenue	8,745	25,295	26,850
Cost of Sales	0	0	0
Gross Profit	8,745	25,295	26,850
EBITDA	(9,319)	(40,910)	6,450
Operating Profit (before GW and except.)	(9,319)	(40,910)	6,450
Intangible Amortisation	0	0	0
Exceptionals	(175)	(1,022)	(5,000)
Other	71,355	22,941	(30,000)
Operating Profit	61,861	(18,991)	(28,550)
Net Interest	(1,564)	(72,613)	(10,750)
Profit Before Tax (norm)	60,472	(90,582)	(34,300)
Profit Before Tax (FRS 3)	60,297	(91,604)	(39,300)
Tax	(19,198)	(7,965)	5,000
Profit After Tax (norm)	41,274	(98,547)	(29,300)
Profit After Tax (FRS 3)	41,099	(99,569)	(34,300)
Average Number of Shares Outstanding (m)	31.7	50.9	49.6
EPS - normalised (p)	130.3	(193.5)	(59.0)
EPS - FRS 3 (p)	129.7	(195.6)	(69.1)
Dividend per share (p)	0.0	0.0	0.0
Gross Margin (%)	100.0	100.0	100.0
EBITDA Margin (%)	N/A	N/A	24.0
Operating Margin (before GW and except.) (%)	N/A	N/A	24.0
BALANCE SHEET			
Fixed Assets	606,738	955,704	814,000
Intangible Assets	497,133	763,558	670,000
Tangible Assets	87,280	149,797	110,000
Investments	22,325	42,349	34,000
Current Assets	111,105	117,111	64,000
Stocks	2,567	22,860	14,000
Debtors	11,542	9,255	6,000
Cash	79,210	66,640	30,000
Current Liabilities	(47,064)	(90,316)	(86,000)
Creditors	(47,064)	(90,316)	(61,000)
Short term borrowings	0	0	(25,000)
Long Term Liabilities	(339,470)	(497,238)	(405,000)
Long term borrowings	(246,635)	(344,080)	(279,000)
Other long term liabilities	(92,835)	(153,158)	(126,000)
Net Assets	331,309	485,261	387,000
CASH FLOW			
Operating Cash Flow	(24,917)	11,787	(21,960)
Net Interest	(4,514)	(16,932)	(10,750)
Tax	(689)	(7,410)	(800)
Capex	0	0	0
Acquisitions/disposals	(341,015)	(16,773)	0
Financing	230,990	(1,960)	(700)
Dividends	0	0	0
Net Cash Flow	(140,145)	(31,288)	(34,210)
Opening net debt/(cash)	27,380	167,425	277,440
HP finance leases initiated	0	0	0
Other	0	(78,687)	37,650
Closing net debt/(cash)	167,525	277,400	274,000

Source: Company accounts/Edison Investment Research